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Before the
FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of Sections of
the Cable Television Consumer
Protection and Competition Act
of 1992)

Rate Regulation)

MM Docket No. 93-215

REPLY COMMENTS OF ARTHUR ANDERSEN & CO.

Arthur Andersen hereby replies to initial comments filed concerning cost of service regulation for cable operators.¹ Our reply comments will address issues raised by interested parties related to the following areas in the Notice:

- Existing rates limitation
- Depreciation
- Excess acquisition costs
- Uniform system of accounts
- Cost allocations

¹ Notice of Proposed Rulemaking in MM Docket No. 93-215 released July 16, 1993 (the "Notice"). Arthur Andersen filed initial comments on the Notice on August 25, 1993 (the "Arthur Andersen Comments").

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EXISTING RATES LIMITATION

Cable operators generally commented that the results of applying cost of service regulation should not be limited by the level of existing rates.² Our comments suggested that a limit based on the rates which were in effect on the date of enactment of the Cable Act of 1992,³ prior to subsequent Commission-mandated rollbacks, would seem most consistent with the intent of Congress. However, our comments also indicated that exceptions to the limit may be warranted in defined circumstances.⁴

From the comments of other parties, and our own initial filing, we believe the criteria which the Commission should use to evaluate such exceptions could include:

- Rates higher than existing levels are needed to attract necessary capital and maintain financial viability.⁵

² See, for example, the comments of the California Cable Television Association at pages 17-19 and the comments of Cable TV of Georgia Limited Partnership, Falcon Cable TV, Insight Communications, Mid-America CATV Association, Mount Vernon Cablevision, Nashoba Communications, Pennsylvania Cable Television Association, Prestige Cable TV, Weststar Communications and Whitcom Investment Company at page 7.

³ Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, enacted on October 5, 1992 (the "Cable Act of 1992").

⁴ Arthur Andersen Comments at pages 13-14.

⁵ Comments of BellSouth Telecommunications, Inc. at page 5 in relation to rates above price caps.

- A significant upgrade or rebuild of the system has occurred, the added cost of which was not reflected or anticipated in setting existing rates.
- There has been a significant change in a cost beyond the control of the cable operator.⁶

The exception criteria described above would, of course, apply equally to initial and subsequent cost of service filings. For example, a cable operator may initially file rates under either the benchmarks or cost of service approach and later have a system rebuild. In that event, a new cost of service determination could produce rates higher than the existing rate limit which would be evaluated against the exception criteria.

DEPRECIATION

Two primary issues arose from comments filed on how depreciation should be determined under cost of service regulation.

⁶ Because rates will be adjusted based on a price cap formula each year, the question of whether a particular cost change is endogenous or exogenous will inevitably arise. Under its price cap plan for common carriers, the Commission requires that cost changes be both beyond the control of the carrier and not reflected in the general inflation index. The Commission must simplify the determination for cable operators to avoid the debate that has occurred over this issue for common carriers. However, in so doing, the Commission should also reconsider its general position that items such as changes in income tax rates and prescribed depreciation rates are endogenous.

- Should the Commission prescribe asset lives/depreciation rates or instead allow cable operators to establish appropriate depreciation practices guided by generally accepted accounting principles (GAAP)?
- If lives or rates are prescribed by the Commission, at what level should they be set (on an overall composite basis or for fixed asset categories)?

Many cable operators believe GAAP provides sufficient guidance and that consequently the Commission need not prescribe asset lives or depreciation rates.⁷ GAAP offers the following definition of depreciation accounting:

*A system of accounting that aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.*⁸

The guidance under GAAP, while sufficient for determining appropriate depreciation practices for overall external financial reporting purposes, requires significant judgement in its application. For that and other reasons, regulators almost

⁷ See, for example, the comments of the National Cable Television Association at pages 25-27 and the comments of Telecommunications, Inc. at pages 25-31.

⁸ Accounting Research Bulletin No. 43, Chapter 9C, ¶ 5.

universally prescribe depreciation lives or rates when a cost of service approach is employed.

Assuming that rates prescribed reflect realistic estimates of useful lives, they serve to provide consistency and uniformity. Arthur Andersen's Comments stressed the need for the prescription process to be simple and to reflect the economic lives of fixed assets.⁹

Concerning the level of detail of prescribed asset lives, we recommended that major categories of assets be distinguished to take account of differences in the technology and other characteristics of cable systems.¹⁰ There is support for such an approach,¹¹ and it has been our experience that even under GAAP, depreciation is often separately computed for major categories of assets. However, to the extent that a reasonable composite depreciation rate can be developed (particularly for small cable

⁹ Arthur Andersen Comments at pages 21-22. It should be noted that the example which illustrated our proposed approach to transitional excess acquisition costs (pages 28-30) contained a simplifying assumption that the Commission had prescribed a 20-year life for depreciating fixed assets. Such assumption was not intended to suggest that 20 years is necessarily the appropriate life. Comments filed by Prime Cable, Harron Communications Corp., Georgia Cable Partners, Atlanta Cable Partners, L.P., Wometco Cable Corp, and The Coalition of Small System Operators ("Prime Cable Comments") at page 40 indicate that 12 years is representative of the average life of cable system physical plant.

¹⁰ Arthur Andersen Comments at pages 21-22.

¹¹ See comments of Viacom International Inc. at pages 48-49.

operators which may not maintain detailed fixed asset records), such an approach would further the Commission's goal of simplification.

EXCESS ACQUISITION COSTS

Arthur Andersen proposed a transition mechanism for excess acquisition costs arising from acquisitions and combinations which occurred prior to the enactment of the Cable Act of 1992. To establish the amount of excess acquisition costs¹² which would be recoverable in cost of service determinations, a four-step process could be used:

1. Determine the current value of fixed assets used to provide regulated cable services, less accumulated depreciation retroactively restated to reflect Commission-prescribed asset lives.
2. Identify costs associated with obtaining and retaining customers on the system ("customer acquisition costs").
3. Add the gross amount obtained in step 1 and the amount

¹² "Excess acquisition costs" refer to the price paid by cable operators to acquire a cable system over and above the seller's net book cost of underlying assets. We use that terminology for convenience rather than to imply that such costs are "excess" in any negative sense.

determined in step 2 and compare with the amount paid for the acquired system to determine that the cable operator did, in fact, pay for such amounts.

4. Subject to the limitation in step 3, add the amounts obtained in steps 1 and 2 to determine recoverable costs of acquired systems. Annual amortization of such costs would be included in operating expenses and the unamortized balances would be included in rate base.¹³

Arthur Andersen's proposal was presented as an alternative between the two polar extremes of full recovery for all excess acquisition costs advocated by many cable operators¹⁴ and no recovery of any excess acquisition costs proposed by other parties.¹⁵ We believe that these parties are in the best positions to argue the relative merits of the threshold issue of recovery which boils down to a question of fairness. Our proposal is intended to offer the Commission an alternative for consideration in the event that a middle ground on this issue is sought.

¹³ Arthur Andersen Comments at pages 26-31.

¹⁴ See, for example, the comments of the National Cable Television Association at pages 10-17 and the comments of Cablevision Systems Corporation at pages 26-28.

¹⁵ See, for example, comments of the Consumer Federation of America at pages 3-4 and comments of Staff of the New Jersey Board of Regulatory Commissioners at pages 6-7.

Current Value of Fixed Assets

Arthur Andersen proposed that "the trended original cost or fair market value" of an acquired cable system could support the inclusion of a portion of excess acquisition costs.¹⁶ Two relevant concerns related to valuing fixed assets were raised in comments filed on the Notice:

- Original cost records do not generally exist for acquired systems.¹⁷ In these situations, trended original cost computations cannot be made.
- Any method of valuation other than original cost is too speculative and results in recovery of hypothetical amounts rather than actual investment.¹⁸

Arthur Andersen's proposal anticipated the first concern by providing for alternative valuation methodologies in cases where original cost records do not exist.¹⁹ Fair market value could be

¹⁶ Arthur Andersen Comments at page 26.

¹⁷ See, for example, the comments of Tele-Media Corporation at pages 11-12 and the comments of Tele-Communications, Inc. at page 17.

¹⁸ See, for example, comments of Economic and Technical Consultants, Inc. at page 3.

¹⁹ In many cases, it is feasible to estimate original cost based on a physical inventory of system assets and knowledge about the type of equipment deployed and the dates of placement in service. Once original cost is determined or estimated, a number

determined by estimating the reproduction cost of the system.²⁰ There are well-accepted industry benchmarks which can serve to establish the reasonableness of such valuations to address the second concern above about "speculative" values. To criticize a valuation approach solely because it involves estimation would also call into question the multitude of other areas where objective estimates are used in the ratemaking process.

An advantage of a current value approach is that it addresses questions about the composition of excess acquisition costs by specifically identifying that portion related to fixed assets. It also takes into account inflation and other factors which are only tangentially considered in rate of return prescriptions under traditional ratemaking. Further, our proposed approach requires a showing that the cable operator has, in fact, paid for the current value of the acquired system. This limitation overcomes the concern that cable operators would earn returns on hypothetical amounts rather than actual investment.

of published indices are available to trend original cost of fixed assets forward to reflect the effects of changing prices.

²⁰ Use of reproduction cost when original cost information does not exist is also recommended in the Prime Cable Comments at page 10.

Customer Acquisition Costs

A number of parties have commented that the Commission should permit recovery of accumulated losses.²¹ In order to obtain and maintain subscribers, cable operators were required to incur substantial upfront franchise, marketing, sales and other costs which could not be recovered through rates during the early years of operation.²² Any approach to valuing acquired cable systems must surely give recognition to "customer acquisition costs" which are a major component of sales prices. The approach proposed by Arthur Andersen would permit recovery of losses resulting from the fact that cable operators were unable to immediately add enough customers to fully recover costs during the start-up phase of operations.

Had cable service been regulated under a cost of service approach at the time many of these expenditures were made, regulators may have permitted such costs to be capitalized or deferred and amortized over a period of time representing the average duration of a subscriber on the system. Under these circumstances, it would have been appropriate for the cable operator to also earn a return on unrecovered amounts of such costs because it would be necessary

²¹ See, for example, Prime Cable Comments at pages 12-16 and comments of Cole, Raywid & Braverman on Behalf of Cable Operators and Associations at pages 53-60.

²² Prime Cable Comments at pages 19-23.

to finance deferred recovery.

The attribution of customer acquisition costs to excess acquisition costs will enable cable operators to better match these costs to the subscribers which benefitted from them. The benefit to subscribers relates to the economies of scope and scale that result from the addition of incremental new customers to a system with a largely fixed cost profile. Again, under our proposed approach, it must be demonstrated that the price paid for the acquired system reflected such amounts.

Customer acquisition costs could be measured in a number of ways. It is unlikely that a detailed accounting for such costs was provided by the seller of a cable system in most cases. One way to define customer acquisition costs is the excess of total costs incurred over revenues during the start-up phase of a cable system.²³ As a practical alternative, it may be advisable for the Commission to establish benchmark amounts for average per customer acquisition costs. We understand that such information is available from analysts and other sources involved in the valuation of cable systems.

²³ Prime Cable Comments at pages 12-16.

UNIFORM SYSTEM OF ACCOUNTS

Arthur Andersen recommended that the Commission prescribe a simplified uniform system of accounts (USOA) for cable operators electing cost of service regulation.²⁴ Cable operators almost universally oppose a USOA, preferring that the Commission only require that accounts be maintained in accordance with GAAP.²⁵ Most cite the administrative burden of implementing a USOA.

One way to mitigate the burden is for the Commission to require that a prescribed account structure and accounting practices be used for reporting purposes only. This would better enable cable operators to maintain books and records in a manner which meets their own needs yet provides the desired consistency of accounting and reporting for purposes of cost of service regulation. The Commission has permitted such latitude to common carriers.²⁶ Rather than prescribing a uniform system of accounts per se, the

²⁴ Arthur Andersen Comments at pages 33-34.

²⁵ See, for example, the comments of Cablevision Industries Corporation, Consolidated Cable Partners, L.P., Crown Media, Inc., Multivision Cable TV Corp., Paracable, Inc. and Providence Journal Company at pages 50-51 and the comments of Time Warner Entertainment, L.P. at pages 36-39.

²⁶ See, for example, C.F.R. Section 32.01(03) which provides "As a general rule, all accounts kept by reporting companies shall conform in numbers and titles to those prescribed herein. However, reporting companies may use different numbers for internal purposes when separate accounts (or subaccounts) maintained are consistent with the title and content of accounts and subaccounts prescribed by this system."

Commission could prescribe uniform reporting for cable operators which would provide the desired consistency of information for cost of service filings.

COST ALLOCATIONS

Arthur Andersen observed that the Commission's principles for regulated/nonregulated cost allocations by common carriers would be equally applicable to cable operators, particularly given that cable operators and telecommunications companies will likely compete in the future.²⁷ Cable operators generally commented that the Commission's existing guidelines are adequate and should not be further prescribed.²⁸

Setting aside the issue of which cost standards are appropriate,²⁹ as in the case of accounting, there is considerable judgement involved in applying cost allocations. The Commission's rules for

²⁷ Arthur Andersen Comments at pages 35-36.

²⁸ See, for example, the comments of Tele-Media Corporation at page 19 and the comments of the Medium-Sized Operators Group (Adelphia Communications, et al) at pages 25-26.

²⁹ In CC Docket No. 86-111, Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Arthur Andersen filed comments on June 30, 1986. Our comments recommended that the Commission adopt a long-run incremental cost standard to segregate the costs of nonregulated activities from regulated services rather than the fully distributed cost approach ultimately adopted by the Commission.

common carriers³⁰ are not overly detailed and would provide the flexibility necessary for cable operators to adapt them to their operations while, at the same time, ensuring a reasonable degree of consistency.

We appreciate the opportunity to reply to comments on the Notice. Any questions regarding our reply comments can be addressed to Mr. Michael P. Huseby, 717 17th Street, Denver, Colorado 80202.

Respectfully submitted,

A handwritten signature in cursive script that reads "Arthur Andersen". To the right of the name is a stylized monogram or set of initials, possibly "A.A." or "V.C.", also written in cursive.

ARTHUR ANDERSEN & CO.

September 14, 1993

³⁰ C.F.R. Section 64.901.